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80-1673
No.

In the Supreme Court of the United States

OCTOBER TERM, 1981

JEFFREY E. FREDERIKSEN and EMERALD CITY CORPORATION, an Illinois corporation,

Petitioners,

v.

EDWARD T. POLOWAY,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTION PRESENTED

Whether (a) fraud charged in connection with the purchase of stock and substantially all of the assets of a corporation involves the sale of a "security" within the scope of the federal securities laws, and (b) an economic reality examination is required for purposes of a motion to dismiss the Petitioner's complaint.

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REFERENCE TO OFFICIAL REPORTER

The opinion of the United States Court of Appeals for the Seventh Circuit is found at 637 F.2d 1147 (7th Cir. 1981).

GROUNDS ON WHICH SUPREME COURT JURISDICTION IS INVOKED

(i) The date of the opinion of the United States Court of Appeals for the Seventh Circuit is January 9, 1981.

(ii) The jurisdiction conferred upon this Court to review the judgment in question by Writ of Certiorari is based upon 28 U.S.C. §1254(1) and United States Supreme Court Rule 20.2.

STATUTES INVOLVED

1. §2(1) of the Securities Act of 1933, 15 U.S.C. §77(b)(1) provides:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, or, in general, any interest or instrument commonly known as a 'security' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

2. §3(a)(10) of Securities Exchange Act of 1934, 15 U.S.C. §78(c)(a)(10) provides:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

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NO.

JEFFREY E. FREDERIKSEN and EMERALD CITY CORPORATION, an Illinois corporation,

Petitioners,

v.

EDWARD T. POLOWAY,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

STATEMENT OF THE CASE

On September 17, 1979, Petitioners filed their complaint in the United States District Court for the Northern District of Illinois, Eastern Division. Through this action, Petitioners have asserted their rights under the federal securities laws, as well as issues under the Illinois Securities Law, a claim for common law fraud and a claim for breach of contract, the last three being before the court pursuant to its pendent jurisdiction.

On November 29, 1979, Respondent filed a Motion to Dismiss the Plaintiff's Complaint for "Failure to State a Cause of Action" alleging that the transaction did not involve a "security" under the federal securities laws. Respondent filed a Memorandum in Support thereof on the same date. On January 3, 1980, Petitioners filed their Memorandum in Response to the Motion to Dismiss the Plaintiff's Complaint. The trial court ruled on February 8, 1980, granting the Respondent's Motion to Dismiss the Plaintiff's Complaint. On March 4, 1980, Petitioners filed a Notice of Appeal. Oral argument was heard on October 31, 1980 before the United States Court of Appeals for the Seventh Circuit and a decision by that Court was issued on January 9, 1981, affirming the judgment of the District Court.

This matter came before the district court's jurisdiction on the basis of Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. §78aa (1976) and Section 22(a) of the Securities Act of 1933, 15 U.S.C. §77(v)(a) (1976). This matter came before the United States Court of Appeals for the Seventh Circuit pursuant to the final disposition of this matter as set forth in the district court's order of February 8, 1980 dismissing the action and 28 U.S.C. §1291.

THE FACTS

During the months of August through October of 1978, the Petitioners Jeffrey E. Frederiksen (hereinafter "Frederiksen") and Emerald City Corporation, an Illinois corporation (hereinafter "ECC"), entered into negotiations for the purchase of assets and stock of a corporation called North Shore Marine, Inc. (hereinafter "NSM"). NSM was in the business of selling, servicing and providing storage facilities for boats at its location in Waukegan,

Illinois. These negotiations were conducted on behalf of NSM by its president and sole shareholder, Respondent Edward T. Poloway (hereinafter "Poloway"). Poloway had been the sole owner of NSM for a number of years, both as a sole proprietor and later as sole shareholder after incorporation. Poloway had been in the boating business for many years previous to this transaction, and though there were few, if any, books and records of NSM maintained by Poloway, Poloway had assured the Petitioners that the business was not only viable, but had excellent potential for vast growth. Respondent indicated to Petitioners, that NSM was in great debt, and that the Respondent did not have the funds to place the business in a position to grow to its capabilities. Petitioners, on the other hand, had no previous experience in the boating business, but were willing to invest large sums of money in the business, based upon the expectation of profit from Poloway's managerial efforts.

During negotiations, Respondent made certain representations to the Petitioners regarding the value of various assets of NSM including intangible property, inventory and accounts receivable. Respondent had made statements to the Petitioners, such that inferences could be reasonably drawn, that Respondent had not disclosed accurately and completely the financial condition of NSM and its assets and liabilities. Petitioners allege that these representations have subsequently been proven not only to be incorrect, but that Respondent knew that such representations were incorrect when made.

On October 14, 1978, Petitioners signed a number of agreements with the Respondent Edward T. Poloway, in Poloway's capacity as sole shareholder of NSM, as President of NSM, and in his individual capacity. The agreements included:

(a) Agreement to purchase immediately 10% of the issued and outstanding shares of NSM by ECC from Poloway and to subsequently cause NSM to redeem the remaining 90% of the stock held by Poloway;

(b) Agreement to purchase assets of NSM by ECC;

(c) Employment agreement between ECC and Poloway;

(d) Management Agreement between ECC and NSM.

The documents show that Petitioners purchased outright 10% of the stock of NSM from Respondent. The remaining 90% of the stock owned by Respondent was held in a voting trust with Petitioner as voting trustee. In order to protect Petitioners from unknown obligations of NSM, Petitioners were then to place $160,000.00 out of a total "asset" purchase price of $191,800.00 in an escrow account to pay obligations of NSM existing as of October 14, 1978. The Agreement to Purchase Stock provides that after all debts of NSM were paid out of the escrow account, the balance of the funds would be paid by NSM to Respondent as the price for redemption of the remaining 90% of the shares of stock held by Respondent. Due to the misrepresentation aforementioned, the Petitioners suffered great financial loss.

ARGUMENT

I. THE FEDERAL CASES ARE IN CONFLICT

A. THIS COURT HAS SET DOWN A TWO-LEVEL TEST FOR DETERMINING WHETHER AN INSTRUMENT IS A "SECURITY" UNDER THE FEDERAL SECURITIES LAWS.

Beginning with *Tcherepnin* v. *Knight,* 389 U.S. 332 (1967), where this Court faced the issue "whether a withdrawable capital share in an Illinois savings and loan association is a 'security' within the meaning of the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. §78a et seq." 389 U.S. at 332, this Court noted two important considerations in defining a security.

The first is that "form should be disregarded for substance and the emphasis should be on economic reality" *S.E.C.* v. *Howey,* 328 U.S. 293, 298 (1946). The second consideration noted in the *Tcherepnin* case is that "Instruments may be included within any of [the Act's] definitions, as a matter of law, if on their face they answer to the name or description, "[Quoting *S.E.C.* v. *Joiner,* 320 U.S. 344 at 351 (1943)]. 389 U.S. 332 at 339.

If these two principles can be reconciled at all, it appears that this Court has promulgated a two level test in determining whether a transaction involves a "security" under §2(1) of Securities Act of 1933 and §3(a)(10) of the Securities Exchange Act of 1934.

Petitioners assert that where the instruments used in the transaction involve corporate stock, they fall within the literal definition of a security as that term is defined

in the federal securities laws, creating a presumption that the transaction is covered by the securities laws. *See Coffin* v. *Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir. 1979). While this may not be the only test to be applied where an instrument other than "corporate stock" is involved, if on its face, corporate stock is involved in the transaction, the federal securities laws do apply. That presumption may be rebutted if an "economic reality" examination of the facts as dictated by *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 850-851 (1975) indicates that the instrument does not have the "significant characteristics typically associated with the named instrument". If such is the case, the instrument would not then fall within the definition of a "security". If the evidence produced at trial does not indicate that an instrument is other than a "security" under the economic reality examination, the presumption holds that a "security" is involved.

This approach was followed by the Seventh Circuit in *Alberto-Culver Company* v. *Scherk*, 484 F.2d 611 (7th Cir. 1973) *rev'd on other grounds* 417 U.S. 506 (1974). In that case the Seventh Circuit had before it an agreement between the Plaintiff and the Defendant that a certain corporation owned solely by the Defendant was to sell 100% of the stock of the corporation to the Plaintiff, along with an agreement between Plaintiff and Defendant for the purchase by the Plaintiff of the assets of three companies owned by Defendant. The Plaintiff alleged that it was defrauded in the acquisition of these businesses in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The question of the District Court's jurisdiction to hear the matter was raised involving the issue of whether the transaction involved a "security" within the purview of Section 10(b) of the Securities Exchange

Act of 1934 and Rule 10b-5. The Seventh Circuit concluded that the sale of the shares and assets of the corporations was the sale of a "security" within the purview of the aforementioned rules.

In its analysis, the court stated:

> "As used in the 1933 (Securities Act) and 1934 (Securities Exchange Act) Acts, security 'embodies a flexible rather than a static principle, one that is capable of adaptation to meet countless and variable schemes devised by those who seek the use of money of others on the promise of profits.' (Citation omitted).
>
> "This mandate to construe broadly the term 'security' compels our conclusions that the agreement to incorporate the SEV entity, and to transfer the assets of the SEV, FLS and Lodeva entities in exchange for cash and promissory notes involves a 'security' within the meaning of the Securities Exchange Act of 1934. *Movielab, Inc.* v. *Berkey Photo, Inc.*, 452 F.2d 662 (2d Cir. 1971); *Lawrence* v. *Securities and Exchange Comm.*, 398 F. 2d 276 (1st Cir. 1968)."

484 F.2d at 615. The Seventh Circuit retained this approach until its decision in the instant case.

In the case of *Occidental Life Insurance Company of No. C.* v. *Pat Ryan and Assoc., Inc.*, 496 F.2d 1255 (4th Cir. 1974), an action involving the sale of all the outstanding shares of an insurance company, the Fourth Circuit held that:

> "[T]he fact that the instruments used in this transaction involve stock and must come within the literal definition of a 'security' creates a strong presumption that the transaction is covered by Section 10(b). It is not necessary for purposes of Section 10(b) that every instrument used in the sale transaction meet the definition of an 'investment contract'."

496 F.2d at 126.

The court quoted the United States Supreme Court in *Tcherepnin* v. *Knight,* 389 U.S. 332 (1967) in stating:

> "instruments may be included within any of (the act's) definitions, as a matter of law if on their face they answer to the name or description."

Clearly, in the case at bar, the sale of stock of NSM falls within the precise definition of a security under Section 3(a)(10) of the Securities Exchange Act of 1934. Therefore, as a matter of law, this transaction falls within the purview of the aforementioned federal securities laws.

Further, in the *Occidental* case, the Fourth Circuit noted that in the sale of certain shares of stock of the corporation there was evidence of fraud in connection with the transfer. In the instant case, there has been no trial in which to present evidence, but on the basis of the facts in the Petitioner's pleadings being taken as admitted for purposes of a motion to dismiss, there is clearly evidence of fraud in connection with a transfer of stock.

The *Occidental* court observed that it did not find persuasive the argument that ordinary commercial transactions should be left to the protection of state laws. In quoting the case of *Supt. of Insurance* v. *Bankers L. and C. Co.,* 404 U.S. 6, 10-12 (1971), the Court noted that Section 10(b) must be read flexibly, not technically and restrictively:

> "Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under Section 10(b), whatever might be available as a remedy under state law."

496 F.2d at 1262. Although the *Alberto-Culver* and *Occidental* cases were decided prior to this Court's decision in *United Housing Foundation, Inc.* v. *Forman, supra,* both

were decided after the *Tcherepnin* and *Howey* cases where the economic reality test for an "investment contract" had its foundation.

In 1975, this Court decided the case of *United Housing Foundation, Inc.* v. *Forman,* 421 U.S. 837 (1975) and further elaborated the "economic reality" examination to determine whether a "security" was involved in a transaction. *Forman* indicates in part that "the touchstone (of a security) is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others". 421 U.S. at 852. In that case, this Court enunciated the test for determining the existence of an "investment contract" cognizable under the federal securities laws, by noting three elements:

(1) An investment in a common venture

(2) premised on a reasonable expectation of profits

(3) to be derived from the managerial efforts of others. *Id.*

To the same effect is *Goodman* v. *Epstein,* 582 F.2d 388 at 406 (7th Cir. 1978).

In *Forman,* this Court stated further:

> "By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, . . . (sale of oil leases conditioned on promoters' agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds . . . (dividends on the investment based on savings and loan association's profits). In such cases the investor is 'attracted solely by the prospects of a return' on his investment. By contrast, when a purchaser is motivated by a desire to use or

> consume the item purchased—'to occupy the land or to develop it themselves,' the securities laws do not apply." (Citations omitted).

421 U.S. at 852-853. The Supreme Court in *Forman* also quoted *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967) as follows:

> "in searching for the meaning and scope of the word 'security' in the Acts, form should be disregarded for substance and the emphasis should be on economic reality."

Therefore, it would appear that the *Howey, Tcherepnin* and *Forman* cases have created the relevant test to be applied by the federal courts in determining whether a "security" is involved under the federal securities laws. In none of these three major cases where this Court has rendered an opinion involving the question of definition of a "security" was the Court required to apply this test to "ordinary corporate stock." *See Coffin* v. *Polishing Machines, Inc.*, 596 F.2d at 1024.

In *Howey*, this Court faced the issue of whether the sale of units of land in a Florida citrus grove coupled with a management contract for cultivating the crops and remitting the proceeds to the owner constituted an "investment contract" under the Securities Act of 1933.

The *Tcherepnin* case involved, as discussed previously, the question of whether a withdrawable capital share in an Illinois savings and loan association constituted a "security" under the federal securities laws, while *Forman* involved the issue as to whether shares of a cooperative apartment complex are "securities". Petitioners maintain that the difference between the above-mentioned transactions and "ordinary corporate stock" only serves to reinforce the two-level test.

Subsequent to the *Forman* decision, the Fourth Circuit decided *Coffin* v. *Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir. 1979). This case involved the purchase by the Plaintiff of one-half of the outstanding shares of the defendant corporation. As a shareholder and officer of the corporation, the plaintiff was to devote his sole efforts towards the business of the defendant corporation. Upon subsequent investigation, the plaintiff learned he had been defrauded and sued under the applicable federal securities acts. The Fourth Circuit, in reversing a dismissal of the plaintiff's complaint for failure to state a claim, stated with respect to the *Forman* case:

> "We do not believe that *Forman* denies a purchaser of ordinary corporate stock the protection of the federal securities laws simply because he intends to participate in the management of the corporation in which he invests. Both the Securities Act of 1933, 15 U.S.C. 77(b)(1) and the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(10), include 'stock' within their definitions of a 'security'. Thus, when a transaction involves stock, there is a strong presumption that the statutes apply. *Occidental Life Insurance Co.* v. *Pat Ryan and Associates, Inc.*, 496 F.2d 1255, 1261 (4th Cir. 1974). *Forman* requires us to analyze the substance of a transaction only when the stocks involved do not have the 'significant characteristics typically associated with the named instrument.' *See Forman*, 421 U.S. 837, 850-51, 95 S.Ct. 2051, 2060, 44 L.Ed. 2d, 621.
>
> Absent some showing that ordinary corporate stocks are other than what they appear to be, we need not consider whether an investor will derive this profit partly from his own efforts. That test, drawn from *SEC* v. *Howey Co.*, 328 U.S. 293, 298, 66 S.Ct. 1100, 90 L. Ed. 1244 (1946), applies to interests not easily recognized as securities in the capital market. It does not apply to stock that comes within the clear lan-

> guage of the securities acts. The court in *Forman*, for example, applied the Howey test only after deciding that the shares under consideration were not like ordinary capital stock."

596 F.2d at 1024.

The two level test Petitioners discussed previously was thus specifically adopted by the Fourth Circuit in *Coffin*. It is obvious that without a trial and the production of evidence, the presumption that "ordinary corporate stock" is other than what it appears to be, cannot be tested.

In the case of *Mifflin Energy Sources, Inc.* v. *Brooks*, [1980] Fed. Sec. L. Rep. Transfer Binder (CCH) ¶97,734 (D. Ct. Pa. 1980), the Pennsylvania District Court faced a situation analagous to the instant case. In *Mifflin*, the Plaintiff purchased 100% of the stock of a business and later filed suit alleging fraud under the federal securities laws. The defendant filed a motion to dismiss the complaint alleging a lack of subject matter jurisdiction on the same basis as the Respondent Poloway claimed in the instant case.

The *Mifflin* court, in analyzing the transaction at issue, stated:

> "In the instant case, however, we are not dealing with a peculiar transaction which may or may not qualify as a securities transaction. The transaction in question here is the sale of 100% of the shares of stock in a coal mining business. The term 'stock' has a common and well accepted meaning in securities law.
>
> > 'Since stock has a traditional and accepted meaning and is indeed one of the most common forms of securities, it is not necessary for the purchase agreement in this case to meet the test generally used to identify an investment contract. What we have here is statutory as well as common law stock. See generally, *Bronstein* v. *Bronstein*, 407 F. Supp. 925 (E. D. Pa. 1976).

Titsch Printing, Inc. v. *Hastings*, 456 F. Supp. 445, 449 (D. Colo. 1978).'

The fact that the subject of the purchase and sale is specifically designated as 'stock' by the parties themselves gives rise to a presumption that we are dealing with 'stock' as it is commonly defined."

The *Mifflin* Court then held that the *Forman* test was not applicable to the facts before it, stating:

"Application of the economic reality test of *Forman* is not necessary here. The present contract is a stock purchase agreement and is so titled. The stock in the corporation has all the traditional attributes of stock, including the right to receive dividends, negotiability, voting rights, and the potential of appreciation in value. There is no evidence to show that what we are dealing with in this transaction is anything other than stock within the definition of the securities laws. Furthermore, *Forman* has been construed to hold:

> . . . [T]hat if the application of the Acts depended in all cases solely upon the economic realities of the transaction, an investor might be unjustly misled by the use of a particular label and form to believe his purchase protected by the securities laws. Consequently the Court stated that when the existence of a covered security is in issue, the name given to an instrument cannot be disregarded, and may, in fact, be highly relevant, especially if the instrument possesses some of the intrinsic features customarily associated with it.

Bronstein v. *Bronstein, supra* at 928."

This approach is also consistent with what the Petitioners allege to be the appropriate application of the federal securities laws.

The Seventh Circuit in its opinion in this case sought to distinguish *Coffin* from the facts at bar by stating:

> "Here, in contrast to the situation in *Coffin*, the transaction did not involve a sale of corporate stock to raise capital for profit-making purposes. The plaintiffs sought to acquire NSM's business in its entirety. The 'stock' sale was a method used to vest ECC with ownership of that business. There was no offer of investment 'securities'."

637 F.2d at 1151.

In dicta, the Seventh Circuit indicated that "the *Coffin* Court's statement of the method of analysis required by *Forman* may be overly broad". *Id.* Clearly there is a conflict among the Circuit Courts of Appeals and also within the United States District Courts.

The Tenth Circuit case of *Chandler* v. *Kew, Inc.* (1979) Fed. Sec. L. Rep. Transfer Binder (CCH) ¶ 96,966 (10th Cir. 1977) involved the sale of a business coupled with a transfer of stock. In that case the Tenth Circuit held that the transfer of stock was "incidental" as an indicia of ownership. The defendant seller had no participation in the business after the transfer unlike the Respondent in the case at bar. The holding of the Tenth Circuit appears to be consistent with the Seventh Circuit's holding in the instant case, but contrary to the Fourth Circuit's holding in *Coffin, supra.*

The Tenth Circuit opinion also appears to be in conflict with the holding in *Mifflin Energy Sources, Inc.* v. *Brooks, supra.* The *Mifflin* court distinguished the *Chandler* case as well as others which involved similar facts by stating that:

> "All of these cases, however, involved a contract for the sale of a business pursuant to which the purchasers were to receive 100% of the stock. The stock

in those was a mere 'indicia of ownership', and not the substance of the sale itself.

In this case, the substance of the sale is 100% of stock in a business. This is clearly evidenced by the terms of the stock purchase agreement. Ownership of the business is a by-product of this transaction, but is not sufficient to remove what is clearly expressed in the terms of the purchase and sale of stock from the purview of the federal securities laws."

The distinction raised by the *Mifflin* court does not appear to be a strong one, in that the same result is accomplished whenever 100% of the stock of a company changes hands. Ownership of 100% of stock is in effect ownership of 100% of a business.

In attempting to distinguish the *Chandler* case and others, the *Mifflin* court attempts to avoid a conflict among the federal courts. The weakness of the distinction however does not weaken the holding of the case; to wit, because corporate stock was sold, the federal securities laws are presumptively applicable to the transaction.

The *Mifflin* court makes another important point by stating that:

"someone who purchases shares of stock whether it be 1 percent of 100 percent also has the reasonable expectation that he is a beneficiary of protection afforded by the federal securities laws. The policy behind the securities laws supports the expectation. *Titsch Printing Co.*, supra at 449."

B. CONGRESSIONAL POLICY IN ENACTING THE SECURITIES LAWS HAS BEEN TO PROSCRIBE FRAUD IN A BROAD DEFINITIONAL AREA WITH RESPECT TO A "SECURITY"

Also important in determining the issue at bar is a further examination of the policy considerations involved herein. In the very recent Third Circuit case of *Weaver*

v. *Marine Bank,* [1980] Fed. Sec. L. Rep. Transfer Binder (CCH) ¶ 97,727 (3rd Cir. December 15, 1980) which involved the issue as to whether a certain type of certificate of deposit was a "security" within the federal securities laws, in reversing the district court's summary determination that a security was not involved, the majority opinion succinctly stated the policy consideration, in part, as follows:

> "The 1934 Act defines securities so broadly as to include virtually every transaction in which an investor might expect to receive a return on his money. It proscribes misconduct not in terms merely of common law fraud subject to all the vagaries of state law, but in the all-inclusive terms 'manipulative acts and practices in connection with a purchase or sale' of a security. Most significantly, it provides in section 27 of the Act, 15 U.S.C. §78aa, one of those comparatively rare instances in which federal jurisdiction is made exclusive. The message is clear that the federal courts have been given a very special responsibility for overseeing the level of permissible conduct in securities transactions. The reason for the congressional decision is equally clear considering the doleful pre 1934 history of securities transactions during which Congress, dependent upon state common law remedies for regulation of the level of conduct in securities transactions, watched standards of fiduciary duty and of representations in the market place descend to the level tolerated in the most tolerant jurisdiction. Given the special responsibility entrusted to them, the federal courts ought to interpret the 1934 Act with presumption of coverage of any transaction which Congress did not expressly exclude. This is especially so when it is remembered that the state courts cannot enforce section 10(b), and thus that the Supreme Court will lack appellate jurisdiction to consider, when a trial is finally concluded in a state court, whether the underlying transaction offended national policy. 28 U.S.C. §1257."

To limit the coverage of the federal securities laws where corporate stock is involved without a trial on the merits would seem to undermine the Congressional policy in enacting these laws in the 1930's.

With respect to the facts in the case at bar, the *Coffin* case involves a very analogous situation. Since "ordinary corporate stock" (as that term is used in *Coffin*) of NSM was purchased, the transaction falls within the literal definition of "security" and a presumption in favor of Petitioners arises.

From the facts in the record before the lower courts, there was no basis to believe that the stock of NSM was other than ordinary corporate stock. Clearly absent from the record was any fact that would show that the NSM stock did not possess any of the traditional attributes of corporate stock, such as, the right to receive dividends, negotiability or voting rights.

For the purposes of a motion to dismiss, as was the situation at bar, the allegations in the complaint must be taken as true with any reasonable inferences drawn in favor of the Petitioner. *Conley* v. *Gibson,* 355 U.S. 41 (1957). See also *Cruz* v. *Beto,* 405 U.S. 319, 322 (1972) and *Scheuer* v. *Rhodes,* 416 U.S. 232, 236 (1974). A court should not dismiss a plaintiff's complaint for failure to state a claim unless it is clear that the plaintiff cannot prove any sets of facts in support of his claim which would entitle him to relief. *Burns* v. *Paddock,* 503 F.2d 18 (7th Cir. 1974).

Since the transaction at bar falls squarely within the literal definition of a "security", combined with the presumptions that arise when a motion to dismiss is raised by a defendant, it appears that the lower courts erred in granting Respondent's motion to dismiss. The presump-

tion that a "security" is involved is a rebuttable one which, during a trial on the merits would allow Respondent the opportunity to rebut, through evidence, the presumption that the stock of NSM is other than "ordinary corporate" stock.

C. UNDER AN "INVESTMENT CONTRACT" APPROACH, THE TRANSACTION AT BAR IS A "SECURITY" UNDER THE FEDERAL SECURITIES LAWS.

Even by utilizing the "investment contract" approach requiring an "economic reality" examination as suggested by this Court in *Forman,* the transaction at bar involved the sale of a "security". When looking to the instant facts, it is clear that the economic reality of the situation involved Petitioners' complete reliance upon the long years of expertise of the Respondent in the business activities relating to NSM. It is equally clear that Petitioners had no experience in the business of selling and servicing boats, and that, but for the continued reliance upon Respondent's expertise and continued managerial efforts toward the business, as evidenced by the employment agreement, the Petitioners would not have entered into this transaction. The Seventh Circuit, in its opinion in this case disputed whether the instant facts here met two of the elements of the *Forman* investment contract test. The first element was that of investment in a common venture. After noting that Petitioners argued that Respondent was entitled to 20% of the gross profits of NSM and that Respondent was still a shareholder of NSM, though his shares were held in a voting trust, the Seventh Circuit stated that Petitioners' argument with respect to the 20% profits (which the Court mislabeled "commission") was hollow since, calling this percentage a com-

mission, there was no pooling of funds as required by *Hirk* v. *Agri-Research Council, Inc.*, 561 F.2d 96, 101 (7th Cir. 1977). This ignores the language of the agreement itself which used the words "gross profits", not commissions. Further the Court seemed to ignore the fact that Respondent was still a shareholder of NSM, and the Court made no statement on this point. Clearly, if Respondent was a shareholder of NSM, this is a sufficient pooling of funds.

As to the other element, profits to be derived from the efforts of others, the Seventh Circuit stated that because Respondent was merely an employee of Petitioner ECC, this was insufficient to satisfy this element of the investment contract "economic reality" test. The "economic reality" of the situation cannot be determined solely by an analysis of the documents involved in the transaction. Nor does *Forman* require such a superficial analysis. Petitioners have alleged that they relied on Respondent's management of the business to earn a profit for them. In looking to the efforts which were to be the "undeniably significant ones" as required by *S.E.C.* v. *Glenn W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973), a court is required to look beyond the mere written documents to the reality of the transaction. In this case, Petitioners have argued that although they were involved in the management decisions, it was Respondent's efforts which were to be the "significant ones". This cannot be ascertained when merely looking to the documents in the transaction, but requires further evidence to be submitted. Clearly, this is required by the cases herein cited. Petitioners argue that there is, in reality, a set of facts upon which Petitioners can prove that they are entitled to relief and therefore granting Respondent's motion to dismiss was improper.

In summary, the federal courts are in dispute on the issue presented herein, and the position set forth by the Fourth Circuit in *Coffin* v. *Polishing Machines, Inc., supra* and other federal courts, is the appropriate position based upon the decisions of this Court and the policies behind the federal securities laws. Further, the Petitioners assert that the facts herein are sufficient to pass the investment contract "economic reality" test as enunciated by this Court in *United Housing Foundation, Inc.* v. *Forman, supra* and its predecessors, and for that reason, the granting of Respondent's motion to dismiss Petitioners' complaint was improper.

CONCLUSION

For the above and foregoing reasons, the Petitioners pray that a writ of certiorari issue from this Court to review the judgment of the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

MARK H. SCHIFF
Chicago, Illinois

Attorney for Petitioners

Of Counsel:
PAUL BERNSTEIN
Chicago, Illinois

APPENDIX

APPENDIX

UNITED STATES DISTRICT COURT,
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

Cause No. 79 C 3817

Honorable JOSEPH SAM PERRY, Presiding Judge.

FREDERICKSEN, et al. vs. POLOWAY

ORDER

This cause comes on upon defendant's motion to dismiss this action. The court has read and considered said motion and the memoranda of the respective parties and finds said motion to be meritorious. Accordingly, it is ORDERED that said motion be and it hereby is granted, and that this action be and it hereby is DISMISSED.

/s/ J. S. Perry

Dated: February 6, 1980

Opinion of Judge Sprecher

JUDGMENT — ORAL ARGUMENT

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

January 9, 1981

Before

Hon. THOMAS E. FAIRCHILD, Chief Judge
Hon. ROBERT A. SPRECHER, Circuit Judge
Hon. RICHARD D. CUDAHY, Circuit Judge

No. 80-1292

JEFFREY E. FREDERIKSEN AND EMERALD CITY CORPORATION, an Illinois corporation,

Plaintiffs-Appellants,

vs.

EDWARD T. POLOWAY, *Defendant-Appellee.*

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

No. 79-C-3817

J. SAM PERRY, Judge

This cause was heard on the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

In the United States Court of Appeals For the Seventh Circuit

No. 80-1292

JEFFREY E. FREDERIKSEN and EMERALD CITY CORPORATION, an Illinois corporation,

Plaintiffs-Appellants,

v.

EDWARD T. POLOWAY,

Defendant-Appellee.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 79-C-3817 — J. SAM PERRY, *Judge.*

ARGUED OCTOBER 31, 1980 — DECIDED JANUARY 9, 1981.

Before FAIRCHILD, *Chief Judge,* SPRECHER, and CUDAHY, *Circuit Judges.*

SPRECHER, *Circuit Judge.* This case involves the scope of the federal securities laws. The question we confront is whether alleged fraud regarding the sale of assets and stock in a corporation falls within the scope of those laws. Not all sales transactions which involve "stock" are necessarily covered by the securities laws. Rather, the test for coverage, in general, is whether the purchaser is placing money in the hands of another who will control the funds

and the business decisions. If, however, the purchaser is assuming control of the critical decisions of the corporation, then the transaction is not considered to involve "securities". Here, we find that the purchaser took control of the corporation. Therefore, this situation does not involve a "security" within the meaning of the federal securities laws.

I

During the months of August through October, 1978, Jeffrey E. Frederiksen and Emerald City Corporation ("ECC") negotiated for, and then purchased, the assets and stock of North Shore Marina, Inc. ("NSM"). NSM was in the business of selling, servicing and providing storage facilities for boats at its location in Waukegan, Illinois. The negotiations culminated on October 14, 1978, with the signing of four agreements. The agreements, signed by Mr. Frederiksen, in his capacity as president of ECC, and by Edward Poloway, in his capacity as president and sole shareholder of NSM and in his individual capacity, were as follows: (1) agreement by ECC to purchase assets of NSM; (2) stock purchase and voting trust agreement; (3) employment agreement between ECC and Mr. Poloway; and (4) management agreement between ECC and NSM.

The purchase agreement provided that NSM would sell its assets to ECC for $191,800. The purchase price was to be paid as follows: $160,000 was to be paid into an escrow account to be used to pay all existing debts of NSM and any unknown liabilities; the balance, $31,800, was to be paid in equal monthly installments over a three year period beginning October 14, 1979.

The stock purchase and voting trust agreement provided that in exchange for $10, Mr. Poloway would sell 10% of the issued and outstanding stock of NSM to ECC,

and, for an additional $10 consideration, would transfer his remaining 90% of the issued and outstanding shares of NSM into a voting trust controlled by Mr. Frederiksen. The agreement also provided that after all debts of NSM were paid out of the escrow account, or earlier at the option of ECC, NSM would pay the balance of the funds to Mr. Poloway as the full price for redemption of his shares held in the voting trust.

The employment agreement provided that for a period of five years, ECC would employ Mr. Poloway to "assist, guide and give his expertise" in all areas of ECC's business. Mr. Poloway was to perform within the "goals, guidelines, directives, policies and procedures" set forth by ECC in return for an annual salary of $32,000. As additional compensation, Mr. Poloway was to receive a consulting fee and a 20% commission on the sale of new boats, accessories, and brokerage sales.

The management agreement granted ECC authority to operate and manage the marina facilities. ECC was to receive as compensation 50% of the gross income derived from the operation of the pavilion at the Waukegan marina. All expenses ECC incurred in operating the pavilion were to be deducted from the remaining 50% of gross income, and the remaining balance was to be paid to NSM. It was the understanding of the parties, however, that the operational expenses, together with the management fees to be paid to ECC under the agreement, would, in all probability, eliminate any income to NSM.

On or about May 11, 1979, ECC terminated its employment agreement with Mr. Poloway. On June 14, 1979, Mr. Poloway filed suit against ECC and Mr. Frederiksen in the Circuit Court of Lake County, Illinois for breach of contract and fraud.

On September 14, 1979, ECC and Mr. Frederiksen filed this suit in the United States District Court for the Northern District of Illinois. Plaintiffs allege that the interests they acquired in NSM are "securities" within the meaning of the federal securities acts and that, in connection with the sale of those interests, Mr. Poloway failed to disclose or misrepresented certain material facts. Plaintiffs claim that Mr. Poloway's conduct violates the 1933 and 1934 securities acts, and they seek to recover $1,250,000 in actual damages and lost profits. Plaintiffs also have asserted pendent claims for breach of the Illinois securities laws, common-law fraud, and breach of contract.

Mr. Poloway moved to dismiss the complaint, arguing that the acquisition of NSM did not involve a "security" within the purview of the federal securities laws. He argued that since there was no diversity of citizenship, there was, thus, no basis for subject-matter jurisdiction. Alternatively, Mr. Poloway argued that the complaint failed to allege fraud with particularity, and that Mr. Frederiksen was not a proper party to the action. The district court granted Mr. Poloway's motion and dismissed the suit. The plaintiffs now appeal that dismissal. We affirm the district court's dismissal on the ground that this transaction does not involve a "security" within the meaning of the federal securities laws.

II

The critical legal issue in this case is whether the plaintiffs' acquisition of North Shore Marina involves a "security" within the meaning of the 1933 and 1934 securities acts. We begin the analysis of this issue with a review of the purpose of the securities laws.

The purposes of and policies behind the securities laws were examined by the Supreme Court in the leading case

of *United Housing Foundation, Inc.* v. *Forman,* 421 U.S. 837 (1975). In *Forman,* residents of a cooperative housing project, who had been required to purchase "stock" in the housing corporation in order to acquire co-op units, filed an action for fraud under the federal securities laws. The Supreme Court held that the shares of stock involved did not constitute "securities" within the meaning of those laws. The Court recognized that:

> The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors.

Id. at 849. The Court emphasized that the securities laws do not apply when the goal of a purchaser is not investment but is a desire to "use or consume the item purchased." *Id.* at 852-53.

Recent decisions of this court recognize that the key to defining the scope of the securities laws is whether the transaction is primarily for commercial (i.e., motivated by a desire to use, consume, occupy or develop), or for investment purposes. *See Canadian Imperial Bank of Commerce Trust Co.* v. *Fingland,* 615 F.2d 465, 470 (7th Cir. 1980) (complaint regarding bank certificates of deposit did not plead securities fraud where it "simply describes a victim whose currency was being held in a commercial transaction and not a victim-investor aspiring for profits"); *Emisco Industries, Inc.* v. *Pro's, Inc.,* 543 F.2d 38 (7th Cir. 1976) (note given as part of sale of all assets of a corporation not an investment where there was no reliance on efforts of others to produce profit).

III

We now turn to plaintiffs' claim that the interests they acquired in NSM constitute "securities" within the meaning of the federal securities laws.[1] First, plaintiffs argue that ECC's purchase of NSM stock falls under the literal wording of the federal securities laws and, for that reason, a legal presumption exists that a security was sold. There are several problems with this "literal application" theory.

The first problem is that the language in the securities acts is not as broad as the plaintiffs contend. Although 15 U.S.C. § 78c(a)(10) ("1934 Act") provides that "[t]he term security means any . . . stock," that definition, as are all the definitions in § 78c(a), is preceded by the phrase "unless the context otherwise requires." 15 U.S.C. § 78c (a). The definition of "security" in the Securities Act of 1933 is prefaced by the same phrase. 15 U.S.C. § 77b(1).

The second problem is that it is not the case that any conduct within the theoretical reach of a statute is necessarily governed by that statute. In *Church of the Holy Trinity* v. *United States,* 143 U.S. 457, 459 (1892), the Supreme Court stated:

> It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.

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[1] Plaintiffs argue in their brief that the securities laws should be presumed to apply because the allegations in their complaint should be taken as true, for purposes of a motion to dismiss. But this argument begs the question. While well-pleaded allegations of the complaint are taken as true for purposes of deciding a motion to dismiss, sweeping conclusions of law and unwarranted deductions of fact are not to be taken as true. *Mitchell* v. *Archibald & Kendall, Inc.,* 573 F.2d 429, 432 (7th Cir. 1978).

The third problem with the plaintiffs' "literal application" argument is that the *Forman* decision and its progeny have specifically rejected that argument. The *Forman* Court stated:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all of the Court's decision in this area:
>
> > "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967).

421 U.S. at 848 (footnote omitted). The *Forman* Court applied an "economic reality" anlaysis, *id.* at 849, in concluding that the purchase of stock to acquire an apartment in a housing cooperative was not an investment and therefore was not within the scope of the federal securities laws. Similarly, the "literal application" theory has been rejected in post-*Forman* cases. *See, e.g., Chandler* v. *Kew, Inc.*, [1979] Fed. Sec. L. Rep. Transfer Binder (CCH) ¶ 96, 966 (10th Cir. 1977) (sale of liquor store where buyer received 100% of stock as indicia of ownership not within federal securities laws); *Bula* v. *Mansfield*, 1979 Fed. Sec. L. Rep. Transfer Binder (CCH) ¶ 96,964 (D. Colo. 1977) (sale of option to buy 100% of stock from sole owner of corporation whose business was ownership and operation of a restaurant was, in economic reality, sale of option to buy restaurant and, therefore, not within federal securities laws).

Finally, the cases cited by plaintiffs in support of their "literal application" argument are inapposite. Two of

the three cases cited, *Alberto-Culver Co.* v. *Scherk,* 484 F.2d 611 (7th Cir. 1973), *rev'd on other grounds,* 417 U.S. 506 (1974), and *Occidental Life Insurance Co. of North Carolina* v. *Pat Ryan & Assoc., Inc.,* 496 F.2d 1255 (4th Cir. 1974), *cert. denied,* 419 U.S. 1023 (1974), were decided before *Forman,* and are, therefore, of little precedential value. The third case, *Coffin* v. *Polishing Machines, Inc.,* 596 F.2d 1202 (4th Cir. 1979), *cert. denied,* 444 U.S. 868 (1979), although decided after Forman, is distinguishable from *Forman.*

In *Coffin,* the president of Polishing Machines, Inc. contacted the plaintiff and encouraged him to purchase stock in the corporation. The president stated that Polishing Machines was offering its stock in order to finance expansion. The parties reached an agreement in which the plaintiff acquired 50% of the outstanding stock of the Polishing Machines and became its executive vice-president. The plaintiff thereafter discovered he had been defrauded in the transaction and sought recovery under the federal securities laws.

The Fourth Circuit reversed the district court's dismissal of the complaint for lack of subject-matter jurisdiction, holding that when "ordinary capital stock" is involved in a transaction, it is covered by the securities laws. 596 F.2d at 1204. In analyzing the transaction, the court stated:

> [T]he descriptive report supplied to Coffin during the negotiations indicates that Polishing Machines wanted to sell stock in order to finance corporate expansion. Thus, the transaction appears to be the very sort of transfer with which the federal securities laws are most concerned, "the sale of securities to raise capital for profit-making purposes." *Forman,* 421 U.S. 837, 349.

596 F.2d at 1204.

Here, in contrast to the situation in *Coffin*, the transaction did not involve a sale of corporate stock to raise capital for profit-making purposes. The plaintiffs sought to acquire NSM's business in its entirety. The "stock" sale was a method used to vest ECC with ownership of that business. There was no offer of investment "securities". The stock of NSM merely was passed incidentally as an indicia of ownership of the business assets sold to ECC.[2] *See* Chandler,[1979] Fed. Sec. L. Rep. Transfer Binder ¶ 96,966, and *Bula*, [1979] Fed. Sec. L. Rep. Transfer Binder ¶ 96,964. For the above reasons, we reject the plaintiffs' "literal application" theory.

IV

Plaintiffs' second argument is that the transaction here meets the requirements of a securities investment under the "economic reality" test announced in *Forman*. The "economic reality" test for determining the existence of a

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[2] Moreover, we note, without deciding, that the *Coffin* court's statement of the method of analysis required by *Forman* may be overly broad. The *Coffin* court stated:

> Forman requires us to analyze the substance of a transaction *only* when the stocks involved do not have the "significant characteristics typically associated with the named instrument."

596 F.2d at 1204, *quoting Forman*, 421 U.S. at 851 (emphasis added).

We are not persuaded that the cited passage supports the *Coffin* court's conclusion. Our reading of *Forman* is that an "economic reality" assessment might be required by *Forman* even if the stocks involved do have some characteristics typically associated with investment securities. As the *Forman* Court stated:

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.

421 U.S. at 849. This language implies that the "economic reality" of a transaction is always a key issue.

security involves three elements: (1) an investment in a common venture; (2) premised on a reasonable expectation of profits; (3) to be derived from the entrepreneurial or managerial efforts of others. *Forman*, 421 U.S. at 852. The first and third elements of this analysis are in issue here.

The first element of the "economic reality" test is whether there is an investment in a common venture. Plaintiffs argue that there was an investment in a common venture here because the employment agreement with Mr. Poloway stated that he was entitled to 20% of the gross profits of NSM, and because Mr. Poloway continued to be a shareholder in NSM, although his stock was placed in a voting trust.

In *Hirk* v. *Agri-Research Council, Inc.*, 561 F.2d 96, 101 (7th Cir. 1977), this court stated that a "sharing or pooling of funds" is required to satisfy the test for a common enterprise. Plaintiffs suggest that because Mr. Poloway received a 20% commission on NSM sales, they and Mr. Poloway "shared" their profits, and thus, there was an investment in a common enterprise. But merely stating the plaintiffs' argument reveals its hollowness. After the sale, Mr. Poloway was an employee of ECC, not a participant in an enterprise whose profits were shared.[3] The fact that an employee receives partial compensation

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[3] The employment agreement between ECC and Mr. Poloway states, in relevant part:

> It shall be the duty of the Employee during the period of this agreement to devote his full time and best efforts to assist, guide and give his expertise in all areas of business in which the Company will be engaged and to operate within the goals, guidelines, directives, policies and procedures as communicated to Employee by Company and to do such other things as may be reasonably required by Company.

in commissions on sales does not transform an employment contract into a securities investment.

The third element of the "economic reality" test,—that profits be derived from efforts of others—presents an even more difficult hurdle for the plaintiffs. Plaintiffs argue that they had no experience in the business of selling and servicing boats and that they relied completely on the managerial efforts and expertise of Mr. Poloway. The first problem with this argument is that it is contradicted by materials in the record on appeal.

Contrary to plaintiffs' argument, the record discloses that the plaintiffs, not Mr. Poloway, were responsible for the continued management of NSM. First, the employment agreement between ECC and Mr. Poloway stated that Mr. Poloway will:

> operate within the goals, guidelines, directives, policies and procedures as communicated to Employee by Company and to do such other things as may be reasonably required by Company.

Second, in plaintiffs' motion to disqualify defendant's counsel, plaintiffs stated:

> In October of 1978 the assets of NORTH SHORE MARINE were sold to the Plaintiff corporation, EMERALD CITY. Further, NORTH SHORE MARINE entered into a management contract with EMERALD CITY CORPORATION which effectively delegated the total management and operation of the business to EMERALD CITY.

Third, in an affidavit attached to the plaintiffs' motion to disqualify defendant's counsel, Mr. Frederiksen stated:

> Affiant, as shareholder and officer of EMERALD CITY CORPORATION, has, since October of 1978, been involved in the operations of NORTH SHORE MARINE, INC.

> Affiant, as President of NORTH SHORE MARINE, INC., has been involved with all management decisions of NORTH SHORE MARINE since the purchase of all of the assets of said corporation of October 14, 1978.

Finally, the stock purchase and voting trust agreement provided:

> Effective upon the date hereof, Edward T. Poloway will tender his resignations as an officer and director of North Shore Marine, Inc., and will cause any and all remaining directors and/or officers to tender their resignations at the same time.

These materials in the record indicate that ECC was assuming management of NSM, not that it was relying completely on the management of Mr. Poloway.

The second problem with the plaintiffs' attempt to meet the source-of-profit requirement of the "economic reality" anaylsis is that the employment relationship they created with Mr. Poloway is not legally sufficient to meet that requirement. As we stated in *Emisco Industries, Inc.* v. *Pro's, Inc.*, 543 F.2d 38, 41 (7th Cir. 1976), "[t]he important element for the transaction to constitute an investment is that [the investor] relied on present and future efforts of another to produce profits." As the Ninth Circuit stated in *S.E.C.* v. *Glenn W. Turner Enterprises*, 474 F.2d 476, 482 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973), the test for determining whether the reliance element has been met is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." Similarly, the Third Circuit has stated:

> [A]n investment contract can exist where the investor is required to perform some duties, *as long as they are nominal or limited* and would have "little direct effect upon receipt by the participant of the benefits promised by the promoters."

Lino v. *City Investment Co.*, 487 F.2d 689, 692 (3d Cir. 1973), *quoting* Sec. Act Release No. 5211 (1971) (emphasis added).

To be sure, ECC expected, and by contract required, Mr. Poloway to give his "best efforts" and "expertise" to NSM and ECC. But Mr. Poloway, as an employee, was not responsible for those "essential managerial decisions," *Turner Enterprises*, 474 F.2d at 482, affecting the conduct of the business. Indeed, Mr. Poloway's "best efforts" were specified by the employment agreement to be "within the goals, guidelines, directives, policies and procedures" of ECC.

Because ECC so strongly assumed management control when it purchased NSM, the ECC efforts were clearly not "nominal or limited," *Lino*, 487 F.2d at 692. Although ECC certainly depended on Mr. Poloway to be a good employee, the fact that plaintiffs took over and operated the business clearly demonstrates that they were not "relying" on Mr. Poloway within the concept of a securities investment.[4]

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[4] *See Emisco Industries*, 543 F.2d at 41 ("As[the buyer] planned to take over and operate the business of [the seller], it is nonsensical to say that it is depending upon [the seller's] current or future efforts to produce a profit"). *See also Shultz* v. *Dain Corp.*, 568 F.2d 612, 615 (8th Cir. 1978) and *Fargo Partners* v. *Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976) (where buyer of apartment complex agrees that seller will manage the complex, buyer retains control and thus does not "rely" on seller within the meaning of a securities investment); and *Commander's Palace Park Assoc.* v. *Girard & Pastel Corp.*, 572 F.2d 1084, 1086 (5th Cir. 1978) (where purchaser bought and leased back mobile home park, and seller undertook substantial responsibilities, because seller's efforts alone were not the "crucial" efforts, the buyer did not "rely" within the meaning of a securities investment).

For the above reasons, we find that this matter does not properly come within the scope of the federal securities laws, under either the "literal application" or the "economic reality" theory. Thus, the district court did not have subject-matter jurisdiction and properly dismissed the two federal securities claims.[5]

V

Plaintiffs' final argument is that the trial court erred in dismissing their pendent state and common law claims. But the plaintiffs' argument is based on their conclusion that the district court had subject-matter jurisdiction of their federal securities claims. Since we find that the district court did not have subject-matter jurisdiction, it follows that the pendent claims must also be dismissed. *See Forman,* 421 U.S. at 860 n.27 and *Chandler,* [1979] Fed. Sec. L. Rep. Transfer Binder (CCH) ¶ 96,966 at 96,054.

For the above reasons, the district court's dismissal of this case is

AFFIRMED.

A true Copy:
Teste:

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Clerk of the United States Court of Appeals for the Seventh Circuit

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[5] Because we find that this matter does not come within the scope of the federal securities laws, we do not reach the defendant's alternate theories that plaintiffs failed to plead fraud with the requisite specificity and that Mr. Frederiksen is not a proper party to this action.